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Discussion of substantive issues related to international cooperation in tax matters: other issues: capacity-building

Capacity development programme in international tax cooperation

Note by the Secretariat

1. In its resolution 2017/2, the Economic and Social Council recognized the progress made by the Financing for Development Office of the Department of Economic and Social Affairs in developing, within its mandate, a capacity development programme in international tax cooperation aimed at strengthening the capacity of the ministries of finance and the national tax authorities in developing countries to develop more effective and efficient tax systems, which support the desired levels of public and private investment, and to combat tax evasion, and requested the Office, in partnership with other stakeholders, to continue its work in this area and to further develop its activities, including relevant practical tools.

2. One of the areas of focus of the above-mentioned programme is on strengthening the capacity of developing countries to increase the potential for domestic revenue mobilization by enhancing their ability to effectively protect and broaden the tax base. The main tool developed in this area is the *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*. First published in 2015, the *Handbook* is being updated and expanded to take into account emerging issues and the latest international developments in this area.

3. The paper contained in the annex to the present note is an abridged version of chapter I of the revised edition of the *Handbook*. It provides an overview of selected issues of particular importance to developing countries in protecting and broadening their tax base.

* E/C.18/2017/4.

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Annex

Protecting the tax base of developing countries*

I. Introduction

General background

1. One of the most significant policy challenges facing developing countries is establishing and maintaining a sustainable source of revenues to fund domestic expenditures. While this problem has many facets, one of the most important is protecting the domestic tax base. In recent years, increasing attention has been paid to cases in which multinational enterprises appear to have paid much lower taxes than expected in view of the applicable headline tax rates in the countries concerned. Several widely publicized cases of well-known companies paying low or no taxes have brought the questions of tax avoidance and evasion into the public political debate. In response to those cases, the Organization for Economic Cooperation and Development (OECD), at the request of the Group of 20 (G20), undertook a project aimed at analysing and addressing the techniques that corporations use to dramatically reduce their effective tax rates. This work led to the development of the Action Plan on Base Erosion and Profit Shifting. The final reports on the 15 actions listed in the Action Plan were presented to and endorsed by the G20 in October 2015.[1]

Developing country perspectives on base erosion and profit shifting

2. While substantial efforts were made to take the viewpoints of developing countries into account in the analysis and outcomes of the work carried out under the OECD/G20 project on base erosion and profit shifting, it was clear from the outset that an independent examination of the problems of tax avoidance and the resulting profit shifting and base erosion from the perspective of developing countries was required. First, most developing countries are primarily, though not exclusively, concerned with the reduction in source-based taxation, rather than the shifting of the domestic income of locally owned companies to low-tax or no-tax jurisdictions. Second, the corporate tax on inward investment typically accounts for a greater share of total revenue in countries with less developed tax systems than in those with more developed tax systems. In addition, the potential responses to base erosion and profit shifting are limited to some extent by the administrative capacity of developing countries.

3. Protecting the domestic tax base against base erosion and profit shifting is necessary if developing countries are to attain revenue sustainability. Capacity development in this area is essential to move towards that goal. The final reports of OECD have much to offer developing countries in terms of identifying issues and suggesting possible techniques to deal with the problems of base erosion and profit shifting, but it is important to keep in mind the special needs and perspectives of developing countries regarding these issues, which include the state of development of the tax system, the administrative resources available to deal with these matters, the nature of the trade and commercial relations with trading partners and regional considerations. Each country must evaluate its own situation in order to identify its particular issues and determine the most appropriate techniques to ensure a sound tax base.

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* This paper is an abridged version of chapter I of the second edition of the *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*, United Nations, New York (forthcoming), which was authored by Hugh J. Ault, Professor of Law Emeritus, Boston College Law School, and Brian J. Arnold, Senior Adviser, Canadian Tax Foundation.

[1] Available at www.oecd.org/ctp/beps-2015-final-reports.htm.

United Nations response

4. In the light of the importance of the issue of base erosion and profit shifting for developing countries and the need for further study and examination, the Committee of Experts on International Cooperation in Tax Matters established the Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries, which was mandated to inform tax officials in developing countries on these issues and facilitate the input of their views and experience into the work of the Committee of Experts and the wider work on the OECD Action Plan.

5. In addition, the Financing for Development Office of the Department of Economic and Social Affairs undertook a project to supplement and complement the work done under the OECD/G20 project and that carried out by the Committee of Experts from a capacity development perspective. The project focused on a number of issues of particular interest to developing countries and included, but was not limited to, the matters covered by OECD in the final reports. The aims of the project were twofold: to provide additional insight into the issues identified in the OECD/G20 project from the perspective of developing countries; and to consider issues involving tax base protection that are of particular importance to developing countries, but that were not addressed in the OECD/G20 project.

6. The first output of the Financing for Development Office project was the first edition of the *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*, which was published in 2015.[2] A second edition of the *Handbook* will be published at the end of 2017, updated to take account of the final results of the OECD/G20 base erosion and profit shifting project. It will also include two new chapters on base-eroding payments of rent and royalties and on controlling tax avoidance through general anti-avoidance rules. The chapters of the *Handbook* were prepared by individual authors, informed by the results of the OECD/G20 project and a review of the existing literature. Most importantly, the *Handbook* reflects the input of developing countries, obtained through the activities of the Committee of Experts and workshops held specifically to catalogue their experience and concerns with respect to base erosion and profit shifting.

7. The following four issues that are of particular concern to developing countries, which were dealt with fully in the *Handbook* but not addressed directly by the OECD/G20 project, are briefly explored in the present paper:

(a) The taxation of capital gains by source countries;

(b) The taxation of services by source countries;

(c) The taxation of rents and royalties by source countries;

(d) The use of statutory general anti-avoidance rules in domestic law.

II. Capital gains

General

8. Foreign direct investment in developing countries can be structured into locally organized subsidiaries or branches of a foreign corporation. In either case, the shares of the corporation may be held by an offshore holding company. If the operating assets in the country are sold, whether they are owned by the foreign corporation or by a local subsidiary, the country will typically have the right to tax any capital gain on the assets, under both its domestic law and any applicable tax

[2] Available at www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf.

treaties. Similarly, if dividends are paid by a domestic corporation, they would generally be subject to a withholding tax. However, if instead of selling the assets directly, the foreign investor sells the shares of the domestic subsidiary or branch of the foreign corporation, source-country tax may be avoided. That would also be the case if the shares of a domestic corporation held by a foreign holding company were sold. Thus, the accrued gain attributable to the underlying assets of the corporation in the source country would escape taxation by the source country on the transfer. This gain may represent appreciation in the underlying assets or retained earnings on which the shareholder would have been taxed if they had been distributed to the shareholder as a dividend. These elements of gain will escape taxation by the source country if the shares are sold unless the domestic law of the source country has special provisions covering such gains and, even if such provisions are in place, in some circumstances tax treaty provisions may prevent taxation of the gain.

Domestic law provisions

9. The structure of the capital gains provisions as they apply to the sale of shares of domestic companies differs substantially from country to country. In some countries, the provisions do not apply to any sales of domestic shares by non-residents, in others, the sale is taxed if the corporation holds certain assets (for example, real or immovable property located in the country) and, in others, a source-based claim may be asserted if the non-resident owns a specified percentage of shares in the domestic corporation regardless of the composition of its assets. In addition, some countries tax the sale of shares only when the transaction is viewed as a matter of tax avoidance: if, for example, property the sale of which would be taxable is transferred to a corporation, then followed closely in time by the sale of the shares of the corporation. There is no clear pattern in the rules of domestic law applicable in this area. The decision on how far to extend source-based taxation to the sale of shares of domestic corporations involves balancing the desire to attract foreign investment with the significance to the domestic tax base of taxing the gains.

10. A number of administrative issues must be considered if a decision is made to tax the sale by non-residents of shares in domestic corporations in certain cases. First, there are several ways to enforce the tax. The seller may be required to report the gain and pay the tax in the same way as if the gain had arisen with respect to assets located directly in the country. This approach may be difficult to enforce, especially if there is no requirement under local law for the sale of shares to be reported by the domestic corporation. Alternatively, a withholding tax obligation might be imposed on the purchaser. However, in the case of a sale between two non-residents, this obligation is difficult to enforce in practice. Additional administrative issues arise if a decision is made to tax the sale of the shares only in cases where there is a tax avoidance element.

Multiple taxation of the same economic gain

11. An additional structural issue is the impact that the sale of the shares might have on the tax status of the underlying assets of the corporation. If the sale of the shares is taxable, but no adjustment is made in the tax cost of the underlying assets, a second tax would be due on the same economic gain when the assets are sold. Whether this pattern of taxation is appropriate will depend on the general structure of corporate-shareholder taxation in the country.

Shares of a foreign corporation

12. Assuming the decision is made to tax the sale of shares of domestic corporations in certain circumstances, a separate question is how to treat the sale of

shares of a foreign corporation that has a domestic permanent establishment or owns the shares of a domestic corporation. There are significant administrative difficulties in implementing a tax on such transfers, in terms of obtaining the information needed to assess the tax and implementing effective methods for collection. Regardless of how the issue of the taxability in general of such transactions is resolved, it may be desirable to have a provision that imposes tax when the transaction can be viewed as involving tax avoidance, for example, when the transfer of the shares of the domestic corporation to a foreign corporation is followed by the immediate sale of the foreign shares or where the foreign corporation is merely a shell corporation.

Treaty aspects

13. If a decision is made to tax capital gains on the sale of shares in domestic or foreign corporations, as well as interests in partnerships and other entities, it is important to consider the extent to which that right should be preserved in tax treaties. Under many treaties, the right of the source country to tax gains on the sale of shares is limited to shares in companies the value of whose assets consists principally of real or immovable property located in the source country. Article 13 (5) of the United Nations Model Double Taxation Convention between Developed and Developing Countries provides for source State taxing rights where the ownership of shares in a domestic corporation exceeds a certain percentage of the total capital of the corporation, regardless of the nature of the underlying assets. In addition, treaty anti-abuse rules may be applicable to protect a source country's right to tax gains from the sale of shares of either domestic or foreign corporations.

III. Services

General

14. The use of payments for services to erode the tax base of developing countries is a serious issue that involves several types of services and the provisions of both domestic law and tax treaties. Domestic law provisions on income from services vary greatly among developing countries. Some countries impose tax on virtually all business services provided by non-residents in the country or to residents of the country; others impose tax only if a non-resident has a permanent establishment or fixed base in the country. Some countries impose a final withholding tax on income from services on a gross basis, while other countries tax income from services on a net basis.

15. It is relatively easy for multinational enterprises operating in a developing country through a resident subsidiary to reduce the tax payable to that country through payments for services rendered by non-resident companies from the same group. Such sums are generally deductible for the purposes of calculating the income of the company resident in the source country, but may not be taxable under the domestic law of that country once received by the non-resident service provider. Even if payments for services performed by the non-resident company are taxable under the domestic tax law of the developing country, an applicable tax treaty along the lines of the United Nations Model Convention or the OECD Model Tax Convention on Income and on Capital would in many circumstances prevent the country from taxing such payments unless the non-resident has a permanent establishment or fixed base in the country.

16. The United Nations Model Convention contains provisions on various types of services. Some types of services, for example, insurance, government services, pensions and the services of directors and top-level managerial officials, do not

provide serious scope for the erosion of the tax base of developing countries and are not dealt with in the present paper. As discussed below, the Committee of Experts has decided to include a new article dealing with income from certain "technical services" in the United Nations Model Convention.

Employment income

17. In general, under both domestic law and the provisions of the United Nations and the OECD Model Conventions, employment income derived by non-residents is taxable by a country only if the employment services are performed or exercised in the country. Under article 15 of the United Nations Model Convention, a source country is prevented from taxing a non-resident on income from employment exercised in the source country if: (a) the non-resident is employed by a non-resident employer that does not have a permanent establishment or fixed base in the source country; or (b) the employer has a permanent establishment or fixed base, the employee's remuneration is not deductible in computing the profits attributable to that permanent establishment or fixed base and the non-resident employee is not present in the source country for 183 days or more in any 12-month period. The same conditions apply under article 15 of the OECD Model Convention, except that the reference to the concept of a fixed base has been eliminated from the OECD Model Convention.

18. The broad scope of the provisions on source-country taxation of income from employment earned by non-resident employees suggests that opportunities for avoidance of source-country tax are limited. Where a non-resident employee's remuneration for employment services performed in the source country is deductible by the employer in computing income subject to tax by the source country, the non-resident employee is usually subject to tax on that remuneration by the source country. The employee's remuneration will usually be deductible if the employer is a resident or a non-resident doing business in the source country through a permanent establishment or a fixed base located in the source country. In these circumstances, the employer is usually required to withhold the tax on behalf of the employee from the remuneration.

19. Nevertheless, a developing country's tax base may be eroded if a non-resident employer avoids having a permanent establishment or fixed base in the source country or if a non-resident individual can alter his or her legal status from employment to independent contractor. A non-resident employee of a non-resident employer without a permanent establishment or fixed base in the source country is taxable only when the non-resident employee is present in the source country for more than 183 days in any 12-month period. If a non-resident is an independent contractor, under articles 7 and 14 of the United Nations Model Convention (only article 7 of the OECD Model Convention), the source country's right to tax is limited to situations where the non-resident has a permanent establishment or a fixed base in the source country and the income is attributable to the permanent establishment or fixed base, or where the non-resident stays in the source country for 183 days or more in any 12-month period. In contrast, a non-resident employee of a resident employer or a non-resident employer with a permanent establishment or fixed base in the source country is taxable on any income from employment exercised in the source country.

Entertainment and sports

20. Some entertainers and sportspersons can make large sums of money in a short period of time. Developing countries that wish to tax income derived by non-resident entertainers and sportspersons must ensure that the provisions of their domestic law and tax treaties allow them to tax such income irrespective of the legal structure of the arrangements. Under article 17 of the United Nations Model

Convention, the country in which the entertainment or sports activities take place can tax the income from those activities.

Business services

21. Under the provisions of articles 7 and 14 of the United Nations Model Convention (only article 7 of the OECD Model Convention), residents of one State are taxable by the other State on their income from services only if the residents carry on business through a permanent establishment or fixed base in the other State. Under article 5 (3) (b) of the United Nations Model Convention, a non-resident enterprise is deemed to have a permanent establishment if it provides services in the other State for 183 days or more in any 12-month period. In addition, a non-resident individual is subject to tax on income from professional or independent services under article 14 of the United Nations Model Convention if the non-resident stays in the other State for more than 183 days in any 12-month period. The rules under articles 7 and 14 do not apply to special types of income from services relating to international shipping and air transportation, entertainment and athletic activities, and employment.

22. The tax base of developing countries can be eroded through the performance of services by non-residents in two main ways. First, if a non-resident service provider does not have a permanent establishment or fixed base in the developing country, any income from services may not be taxable under the domestic law of the developing country or the provisions of an applicable tax treaty. Moreover, even if the non-resident service provider has a permanent establishment or fixed base in the developing country, that country cannot tax income from services that is not attributable to the permanent establishment or fixed base. Second, if the services are provided outside the developing country but are deductible in computing the payer's income for tax purposes in the developing country, the country may be unable to tax the income under its domestic law or the provisions of an applicable tax treaty. If the non-resident service provider has a permanent establishment or fixed base in the developing country, the income attributable to the permanent establishment or fixed base under the provisions of articles 7 and 14 of the United Nations Model Convention may include foreign source income, if, for example, the remuneration of the employees performing the services is deductible in computing the profits of the permanent establishment or fixed base. Nevertheless, unless taxes can be imposed on the foreign source income of a non-resident under domestic law, the provisions of an applicable tax treaty allowing the country to tax such income will have no effect.

23. There are several ways in which taxpayers can structure their affairs to avoid having a permanent establishment or fixed base in a country. For example, non-resident service providers might provide services at various locations in a developing country without being based in any one place for more than six months or they might use the fixed place of business of a client or a related enterprise. Although the commentary on article 5 of both the United Nations and the OECD Model Conventions indicates that a permanent establishment may exist in such situations,[3] the tax administration of the developing country may not have the necessary information-gathering resources to discover the facts required to show that there is a permanent establishment or fixed base. In other situations, a non-resident can avoid having a permanent establishment or fixed base by fragmenting its activities among related enterprises or by using related non-resident enterprises to carry out connected projects. Under article 5 (3) (b) of the United Nations Model Convention, any services performed for the same or a connected

[3] See paragraph 3 of the commentary on article 5 of the United Nations Model Convention, quoting paragraph 4 of the commentary on article 5 of the OECD Model Convention.

project are aggregated for the purposes of counting the number of days on which services are provided in the source country. There is no rule, however, to take into account services provided by related enterprises with respect to the same or connected projects. The same concern applies to construction projects under article 5 (3) (a) of the United Nations Model Convention. Specific anti-avoidance rules in domestic law or tax treaties might be useful in this regard, although the application of such rules requires effective information-gathering by the tax authorities of the developing country.

24. In the OECD final report on action 7 of the Action Plan,[4] it is suggested that the fragmentation of construction activities among related enterprises can be dealt with by the new general anti-avoidance rule to be added to the OECD Model Convention. However, the final report also provides a specific anti-avoidance rule in the commentary for those countries that prefer to deal with the problem through a specific rule. Similarly, the amendments to the United Nations Model Convention, approved in 2017, include a general anti-avoidance rule and an optional specific anti-avoidance rule in the commentary to deal with the fragmentation of construction activities. Moreover, article 5 (3) (b) was revised to delete the requirement that the activities must be "for the same or a connected project". As a result, if a non-resident performs services in a country for 183 days or more, the non-resident is deemed to have a permanent establishment in the country irrespective of whether the services are provided for the same or connected projects.

25. A multinational enterprise carrying on business in a developing country may use another company in the same group resident in a low-tax country to provide various services to the company in the developing country. These services, which often include legal, accounting, management and technical services (see the section below on technical services), may not require employees of the non-resident service provider to be present in the developing country for long periods of time. It is difficult for developing countries to counteract this type of tax planning even with effective anti-avoidance rules in place. Some countries have insisted on a period shorter than 183 days in order to minimize this limitation on their ability to tax.

Technical services

26. Some developing countries have special rules in their domestic law and tax treaties on income from technical services. Under these rules, such services are subject to a final withholding tax on a gross basis at a flat rate and the resident payer for the services is required to withhold tax from the payments to the non-resident service provider. The types of services to which the rules apply often include managerial, technical and consulting services, but these are not defined precisely.

27. Neither the United Nations Model Convention of 2011 nor the OECD Model Convention contains any specific provisions dealing with income from technical services. As noted above, in general, income from business services is covered under articles 7 and 14 of the United Nations Model Convention and is taxable only if the non-resident has a permanent establishment or a fixed base or spends a significant amount of time in the source country. The high threshold for the imposition of source-country tax on income from business services means that it is relatively easy for non-residents to provide technical services to customers in a source country without becoming subject to source-country tax. Since the payments for the services are usually deductible by the payers (either residents of the source country or non-residents with a permanent establishment or fixed base in the source

[4] OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 — 2015 Final Report* (Paris, 2015), available at www.oecd-ilibrary.org/taxation/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report_9789264241220-en.

country), fees for technical services can lead to serious base erosion in source countries.

28. The erosion of a source country's tax base by payments for technical services and the inability of the source country to tax such payments have led some countries to add specific provisions to their domestic laws and tax treaties to allow them to tax payments for technical services on a gross basis.[5] A 2011 survey by the International Bureau of Fiscal Documentation found that 134 of the 1,586 tax treaties concluded between 1997 and 2011 contained a separate article dealing with fees for technical services.[6] Under the separate articles, income from technical services is treated in the same way as royalties: source-country tax is allowed on a gross basis at a fixed rate, but is limited to fees for technical services "arising" in the source country, which usually means that the services must be performed in the source country. As noted above, these separate articles dealing with fees for technical services typically refer to managerial, technical or consultancy services, without defining those services. Under other treaties, the provisions of article 12 of the United Nations Model Convention dealing with royalties were extended to include payments for certain technical services.

29. Since 2008, the Committee of Experts has been working on the provisions of the United Nations Model Convention dealing with the taxation of income from services. In 2017, the Committee approved the addition of a new article, to be numbered 12A, to the United Nations Model Convention, which will allow source countries to tax fees for technical services on a basis similar to the taxation of royalties, that is, on a gross basis at a limited rate without any threshold requirement, even if the services are provided outside the source country. If developing countries are successful in negotiating the inclusion of this new article in their tax treaties, they will be able to protect their domestic tax base from erosion through payments to non-residents for technical services.

IV. Rents and royalties

General

30. While the OECD final reports deal with some issues involving intangibles and payments for intangibles, they address the base erosion and profit shifting problems that can arise in connection with rents and royalties only from a transfer pricing perspective. From a developing country perspective, rental and royalty payments can raise significant problems in connection with protecting the tax base. As is the case for interest and services, the payment may be deductible for the payer, thus reducing the domestic tax base, while being subject to no or limited taxation for the recipient. In addition, differing domestic law treatment of rents and royalty payments may lead to the structuring of "hybrid" transactions to take advantage of those differences.

Definitional issues

31. While domestic law definitions vary substantially, the core concept behind the notion of rent or royalty is a payment for the right to temporarily use tangible (rents) or intangible property (royalties). There are a number of difficult definitional issues arising from this basic concept. First, while payments may nominally be for

[5] See S. B. Law, "Technical Services Fees in Recent Treaties", (2010) Vol. 64, No. 5, *Bulletin for International Taxation*.

[6] See W. Wijnen, J. de Goede and A. Alessi, "The Treatment of Services in Tax Treaties" (2012), Vol. 66, No. 1, *Bulletin for International Taxation*.

the temporary use of the property, they may in fact constitute partial payments for the actual transfer of the property, as well as an implicit interest charge for the payments over time. Where the tax treatment of dispositions of property and the payment and receipt of interest differ from the treatment of royalties, taxpayers will have an incentive to structure transactions to obtain the most advantageous tax outcomes. Similarly, the return from an intangible may be embedded in the sale price of a produced good, while the taxpayer could achieve a different tax outcome by arranging for the intangible to be licensed to a related party, which manufactures the good. In addition, it may be difficult to draw the line between the use of property and the provision of technical services. Thus the design of domestic law provisions dealing with rents and royalties must take into account the possible substitution of rent or royalty payments for other payments that receive a different treatment.

Jurisdictional basis for the taxation of rents and royalties

32. Countries typically claim the right to tax rents or royalties that have a source in the jurisdiction. The source may be determined by the place of use of the property or by the tax status of the payer of the rents or royalties. Typically, if a resident taxpayer or a non-resident taxpayer with a permanent establishment in the country deducts the rent or royalty payment, the payment will be deemed to have a source in that country, thus allowing the country to recapture some of the tax revenue lost by virtue of the deduction. In this context, it is important for countries to ensure that their right to tax under international treaties is reflected in their domestic law provisions on taxing rental or royalty payments.

Structure of the tax on rents and royalties

33. Payments of rents and royalties to non-residents, which are not connected with a permanent establishment, are typically subject to a withholding tax obligation on the payer, imposed on a gross basis at a relatively low rate without any particular threshold. Under tax treaties, the rate imposed is often low or the tax is eliminated entirely. Where the royalty payment is deducted by a resident taxpayer or the permanent establishment of a non-resident taxpayer and taxed in the hands of the recipient at a low rate, there is a significant risk of base erosion. The level of royalty payments also involves transfer pricing issues.

Mixed contracts

34. Many contractual arrangements involve a combination of different elements: sales combined with the use of tangible or intangible assets, services combined with the use of equipment, and rentals of immovable property (for example, land, farms, houses or hotels) combined with rentals of movable property (for example, equipment, furniture or animals). If the different elements of a mixed contract are treated differently under domestic law and tax treaties, it will be necessary for the tax authorities to determine the amount of the payments under the contract that is attributable to each of its elements. Moreover, the parties to the contract, regardless of whether they are related, may be tempted to split the contract into several elements or to price some of the elements in order to avoid or reduce tax. Therefore, it is important for the tax authorities to identify the various elements of a mixed contract and ensure that the price for each element is correct.

Mismatch arrangements and intermediary companies

35. Often mismatches between the characterization of a transaction under the respective domestic laws of two countries are used to take advantage of the differing treatment of royalties and other payments. For example, if one country determines

ownership on a strictly legal basis and the other looks to the economic substance of the transaction, a payment of royalties may be deducted in one jurisdiction while being treated as a financing transaction involving interest payments and depreciation in the other jurisdiction. In addition, the ownership of intangibles can easily be transferred to related entities, which can create base erosion problems when intermediate companies based in low-tax jurisdictions are involved.

V. Statutory general anti-avoidance rules in domestic law

General

36. Abusive or aggressive tax avoidance arrangements erode a country's tax base and undermine public confidence in the integrity of the tax system. These arrangements pose serious problems for the income tax systems of all countries and a variety of methods are used to control them, including specific anti-avoidance rules, judicial anti-avoidance doctrines, purposive interpretation of tax legislation and robust enforcement efforts. However, these methods, even when combined, have often proved inadequate to deal effectively with abusive tax avoidance. As a result, many countries have adopted general anti-avoidance rules that potentially apply to all types of payments, receipts, taxpayers and transactions, including cross-border transactions. The purpose of a general anti-avoidance rule is to stop taxpayers from using abusive tax avoidance arrangements that reduce a country's tax base, while not discouraging legitimate commercial transactions. Thus, such rules must distinguish in some way between abusive tax avoidance transactions and legitimate commercial transactions.

37. The adoption of a general anti-avoidance rule is usually controversial. Taxpayers and their advisers typically raise several arguments against the adoption of such rules, in particular, that they are unnecessary because the tax authorities have other tools at their disposal for dealing adequately with abusive tax avoidance and that the uncertainty they cause for taxpayers discourages legitimate commercial transactions. Nevertheless, many countries have concluded that they need a general anti-avoidance rule and that the inevitable uncertainty it generates can be minimized by providing administrative guidance on its application.

The major features of a statutory general anti-avoidance rule

38. Typically, a general anti-avoidance rule applies if a transaction that results in tax benefits is carried out for the sole or principal purpose of obtaining those benefits and if such benefits are contrary to the object and purpose of the tax legislation. General anti-avoidance rules usually have the following four main features:

(a) The definition of a transaction, scheme or arrangement;

(b) The definition of a tax benefit;

(c) A purpose test that requires the principal or one of the principal purposes of a transaction or arrangement to be determined;

(d) An exception, additional condition or saving provision to ensure that the general anti-avoidance rule does not apply to transactions or arrangements that do not abuse, frustrate, defeat or contravene the underlying purpose or policy of the relevant provisions of the tax legislation.

39. Typically, countries use terms such as "transaction", "arrangement" or "scheme" as basic building blocks for identifying the target of their general anti-avoidance rules. Some countries define the relevant terms comprehensively and explicitly and other

countries leave them largely undefined, relying on the tax administration and the courts to interpret them broadly. Most importantly, the rule must apply to a series of transactions, since most aggressive tax avoidance arrangements involve multiple connected transactions. A series of transactions for this purpose should be defined broadly to include any transaction that is related or connected to, or carried out in contemplation of, another transaction or transactions.

40. A general anti-avoidance rule applies only to transactions, arrangements or schemes that would result in the avoidance or reduction of tax if the rule were not applied. For this purpose, many countries use the term "tax benefit", defined broadly to mean any avoidance, reduction or deferral of tax payable. Some countries also include in their definition of tax benefit the avoidance, reduction or deferral of amounts related to tax payable, such as interest and tax instalments. The requirement of a tax benefit is not intended to establish a high threshold or difficult condition for the application of the rule.

41. Most general anti-avoidance rules contain a purpose test: in effect, if none of the primary purposes of a transaction or arrangement is obtaining a tax benefit, the rule should not apply. However, if the primary purpose or one of the primary purposes is to obtain a tax benefit, the rule applies unless, in the case of most such rules, the transaction or arrangement is consistent with the underlying policy of the tax legislation. Most countries use a sole or main purpose test, which requires the tax authorities and the courts to weigh the purposes of a transaction in order to determine its main purpose. The onus of proof can be an important factor in this determination. Some countries put the onus on the taxpayer by explicitly providing in the general anti-avoidance rule that the purpose test is met unless the taxpayer establishes that the primary purpose of the transaction was something other than obtaining the tax benefit. A "one of the main purposes" test is used by a few countries and is reflected in the United Nations and the OECD Model Conventions. Such a test is relatively easy to satisfy. If a transaction results in a significant tax benefit, it would seem unlikely that none of the main purposes of the transaction was obtaining that benefit. Therefore, it is especially important, if a "one of the main purposes" test is included in a general anti-avoidance rule, that an exception should be included for transactions that have the reduction of tax as one of their main purposes, but which are in accordance with the object and purpose of the tax legislation.

42. Any purpose test should be based on objective facts and circumstances rather than the subjective intention of the taxpayer and this is the case with respect to the general anti-avoidance rules in most countries, which refer to the purpose of a transaction rather than the purpose of the person carrying out the transaction.

43. Most statutory general anti-avoidance rules provide an exception for transactions that are consistent with and not contrary to the object and purpose of the tax legislation and therefore do not apply to all transactions or arrangements that are carried out primarily for the purpose of obtaining a tax benefit. This exception is an important safety valve for transactions that have the primary purpose of reducing tax but are nevertheless legitimate commercial transactions. Most commercial transactions have important tax implications that taxpayers would not wish to ignore, however, many of them, and the tax benefits they produce, are consistent with the underlying purpose of the tax legislation. In the absence of an exception for transactions that reduce tax but are not contrary to the underlying purpose of the tax legislation, the tax authorities would be required to exercise their discretion, without any statutory guidance, in order to ensure that the general anti-avoidance rule is not applied to such transactions.

44. The exception for tax avoidance transactions that are not contrary to the purpose of the tax legislation can be worded in a wide variety of ways. Some countries refer explicitly to the object and purpose of the legislation; other countries refer to transactions that involve a misuse or abuse of the legislation or that are artificial in some way. For some countries, the exception is implicit in the general anti-avoidance rule as a matter of interpretation. Whichever approach is taken to provide such a safety valve, it is often difficult for the tax authorities and the courts to determine with any certainty the purpose of the relevant provisions of the tax legislation. This problem of interpretation is especially difficult when the purpose of the provisions of the tax legislation is not explicitly stated in the legislation or in any accompanying explanatory notes.

The relationship between a general anti-avoidance rule and the provisions of tax treaties

45. A fundamental principle of the law of treaties is that, in the event of a conflict between the provisions of a treaty and the provisions of domestic law, the provisions of the treaty must prevail. This principle is enshrined in article 26 of the Vienna Convention on the Law of Treaties. The application of this principle would appear to suggest that if an abusive tax avoidance arrangement results in benefits under a tax treaty, those treaty benefits must be granted even where the arrangement is subject to a country's domestic general anti-avoidance rule. Before the changes to the commentary on article 1 of the OECD Model Convention in 2003, this was arguably the result. For this reason, some countries enacted special legislation to ensure that their domestic general anti-avoidance rules apply in the event of a conflict with the provisions of a tax treaty, a so-called "treaty override", and other countries have insisted on the inclusion of specific anti-avoidance rules in their tax treaties.

46. In 2003, the commentary on article 1 of the OECD Model Convention was substantially revised to indicate that for most OECD member countries, there is no conflict between domestic anti-avoidance rules and the provisions of tax treaties. The provisions of tax treaties should therefore not be interpreted and applied to prevent the application of domestic anti-avoidance rules. Moreover, the commentary stated explicitly that tax treaties were not intended to facilitate tax avoidance and that it was not necessary for specific anti-avoidance rules to be included in tax treaties or for the application of domestic anti-avoidance rules to be protected in tax treaties. The commentary on article 1 of the United Nations Model Convention was revised in 2011 to adopt the OECD position on the relationship between domestic anti-avoidance rules and the provisions of tax treaties.

47. In the light of the 2003 revisions to the commentary on article 1 of the OECD Model Convention and the 2011 revisions to the commentary on article 1 of the United Nations Model Convention, the question is raised as to whether the revised version of the commentary should apply to a tax treaty that entered into force before the commentary was revised. Not surprisingly, taxpayers and their advisers generally take the position that only the version of the commentary applicable at the time the treaty was entered into should be relevant for purposes of interpreting the treaty. However, the OECD takes the position that the current version of the commentary applies to all tax treaties regardless of whether they were concluded before or after the commentary was revised.

48. In the amendments approved in 2017, a general anti-avoidance rule was added to both the United Nations and the OECD Model Conventions (article 29 (9)). The rule provides that treaty benefits can be denied if one of the principal purposes of a transaction is to obtain those benefits, unless granting those benefits is in accordance with the object and purpose of the treaty. In effect, the interpretive

guiding principle added to the commentary on article 1 of both the United Nations and the OECD Model Conventions, in 2011 and 2003, respectively, has been moved into the text of the Conventions. As a result, for countries that have domestic general anti-avoidance rules, the question is whether their domestic rules are consistent with the treaty rules and, if not, what are the consequences.

VI. Conclusion

49. The protection of the tax base of developing countries is an essential element in establishing domestic revenue sustainability. Identifying the features of their tax systems that facilitate base erosion and profit shifting will allow developing countries to assess the impact that such provisions have and to develop the appropriate measures to take in response. Once the problem has been identified, the next step is the implementation and administration of those solutions that are best suited to the particular circumstances of each country. Although there is no one answer to the issues of base erosion and profit shifting, a careful choice among the possible approaches can lead to substantial improvements in the revenue-raising capacity of the tax systems of developing countries.